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DOW THEORY LETTERS

"THE MARKET AS INTERPRETED UNDER THE DOW THEORY"

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QUESTION. If both averages had violated the lows at C (see chart), would this have signaled the end of the third phase? If not, what would it have meant?

ANSWER. The penetration of point C would not have signaled the end of the third phase. It would have been a bearish signal predicting lower prices and the possible beginning of a secondary reaction. It is important to understand the difference between a mere decline and a secondary reaction. A secondary entails two factors, duration and extent. Secondaries last approximately three weeks to three months. They tend to correct one-third to two-thirds of the previously uncorrected primary advance. A decline may be defined as any downward move exceeding 3%. It is helpful to know that almost all secondaries form a zig-zag pattern. The first downward movement in a secondary may be a steady drop lasting a few days. Then there is a little advance, followed by another downward move which violates the first low. In other words, secondaries are seldom straight-line drops; their first bottom is almost invariably broken downside. The B-C formation was a simple decline. Its low-point (C) was not violated. This is the reason that I stated that a penetration of C by both averages might have developed into a secondary.

True bear market signals can be recognized by the following formation. First we would have a full secondary reaction. Following this, both averages would advance for a period of a few weeks or so, correcting the secondary reaction. If, on this return to the highs, one or both averages refused to better those highs, and they then turned down and broke the lows of the secondary, a bear market signal would have been given.

Referring to the present bull market, industrials have now advanced about 150 points above the 419.79 lows of October, 1957. This advance has so far remained uncorrected. The recent B-C decline (see chart) erased 25 points from the industrial average. This decline lasted a mere three days and corrected only 17% of the entire third phase advance since the October, '57 lows. Both in duration and extent the B-C decline fell far short of being a secondary.

Let us say that both averages had broken C and then had extended their decline so that industrials were at least 40-50 points below the highs of B and rails had retraced about the same distance in percentages. If this downward move had lasted three weeks or longer, we would then be entitled to call it a true secondary reaction. Following all this, sooner or later an advance would take place. Assuming that this advance fully corrected the secondary both in duration and extent, say a three week advance bringing both averages most of the way back to B, and volume tended to diminish as this advance approached the highs, we would at this point be extremely suspicious. If one or both averages refused to hurdle the highs (we should be selling our holdings here), and they then turned down on increasing volume, at the point where they violated their secondary lows we would know that a bear signal had been given. We would also say that a bear market had been in progress since the highs of B.

It is important to note that if point C had been violated by both averages a secondary would not necessarily have followed. It is possible that the market might have declined another 5%, perhaps even less. The penetration of C would have been the first bearish minor formation since the October, '57 lows. Bearish indications and bear signals are two vastly different things, however, and should not be confused. Every bull market has many bearish minor signals throughout its lifetime but only one bear signal.

I want to point out that the psychological atmosphere at this time is not what I would expect at the top of a bull market. I do not see the usual signs such as the crowd pouring into the market, excessive volume, gigantic distribution by investors, or of stocks

generally moving into weak hands. As discussed before, the fundamental outlook is always exceedingly bright at about the time a bear signal is given.

DOW THEORY. In letter 49 I mentioned that "volume indications lead me to believe that the coming move will be upward." I will now repeat this statement with even more emphasis. Following my last letter, industrials staged a single-handed rally unaccompanied by any significant movement in the rails. The rail average, in fact, seemed to be making a "line" all by itself. Such a formation (even on one average) suggests that buyers and sellers are very evenly matched. If the rail buyers were better informed than the rail sellers, a rail advance would be the eventual outcome. If the sellers proved to be the more knowing group, we would expect rails to decline.

On December 23, industrials declined as volume shrunk to its lowest level since September 5, a mere 2,870,000 shares. Readers who studied the buy-spot paragraph in my last letter might have recognized this little price-volume dip as a classic opportunity to purchase stocks. Despite the widespread talk of tax-selling, literally no stock was offered on lower prices. A more bullish indication would be hard to find. Despite this, many of my readers told me that they felt the market looked shaky, and that they expected further tax-selling. December 24 provided the answer as industrials rose over $6 and rails leaped out of their four week line to close within a dollar of their highs for the year at B. This advance was the more impressive because it showed the extreme sensitivity of prices to any slight increase in volume. The implications here are that on lowered bids, offerings of stocks are being withdrawn. On slight buying pressure stocks rally sharply in a thin market. A rail confirmation through point B would now be the final signal needed to make the situation almost explosive, but as stated before, we do not have to wait for a confirmation, under Dow Theory, in order to buy.

OPINION. I will venture a guess that the rails will confirm the industrial highs before the end of this week, and that this will find us in an advance that may well amaze some of the cautious advertisers who have been airing their warnings in the nation's periodical and newspapers. Readers should remember that this is only my opinion and not yet the verdict of the averages. (Written December 28).

Of the financial writers and the new year, Hamilton used to say that "The reviews were always better than the forecasts." Since this writer agrees heartily, I will spare my readers the forecast, but I will wish them a very happy and prosperious 1959!

STOCKS TO BUY. U.S. Steel is in a bullish ascending triangle. It looks excellent on the charts. I like Republic Steel also. Most of the steels seem to be in excellent patterns. International oils are in rather bearish formations (descending triangles), and I have switched many of my Internationals into U.S. Steel.

Baltimore & Ohio R.R. looks good as does Southern Pacific. Most of the rails, in fact, look like buys on the charts.